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EU Proposes Harmonisation of Corporate Insolvency Proceedings

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On 7 December, the European Commission (EC) announced plans to harmonise insolvency proceeding rules across the 27 EU member states. Although harmonisation of insolvency legislation across the EU is not a new objective for the EC, the EC has now published a draft proposal for a directive of the European Parliament and of the Council harmonising certain aspects of insolvency law (2022/0409 (COD)) (the Directive).

The Directive proposes to create common minimum standards across all member states, with a view to promoting freedom of capital movement in the EU and greater integration of the EU's capital markets.

The Directive is focused primarily on formal insolvencies rather than pre-insolvency/rescue matters. Broadly, it covers standardisation of avoidance actions, asset tracing, directors' duties and liability, sale of a company/its assets through "pre-pack proceedings", the insolvency trigger, and a simplified regime for micro or small enterprises. We have covered the main areas in more detail further below.

Where Do We Stand Now?

In the past, harmonisation of EU insolvency rules has moved at a slow pace and met with some resistance from member states. However, the COVID-19 pandemic, and the resulting shock to the market, has already somewhat accelerated convergence of insolvency rules among member states through "bottom-up harmonisation", whereby member states have themselves bolstered their domestic insolvency and restructuring rules and legislation. Although these developments have been uncoordinated, the common goal appears to be rescue of viable companies that are showing signs of distress, and facilitating restructuring at an earlier point in time via "debtor-in-possession" style restructuring processes.

What Is Being Proposed Under the Draft Directive?

The Directive aims to harmonise three key areas of corporate[1] insolvency laws across the EU:

1. Maximising Creditor Recoveries From Liquidated Companies

The proposals introduce a minimum set of conditions with a view to maximising potential recoveries for creditors. These are:

Asset tracing – The proposals aim to improve asset tracing and propose that insolvency practitioners have expeditious access to beneficial ownership registers, bank account information and national asset registers across member states. Access conditions imposed by a member state must be the same regardless of which member state the insolvency practitioner has been appointed in.

Directors' duties – The proposals acknowledge that delayed intervention can cause asset dissipation, which in turn leads to lower recoveries for creditors. It is therefore proposed that directors are obliged to ask the court to open insolvency proceedings within three months of their becoming aware (or from the point in time at which they can reasonably be expected to become aware) that the company is insolvent (note that this does not preclude member states from adopting a stricter timetable). The Directive does not provide a harmonised definition of "director", but the explanatory notes state "the term director should be understood broadly", and therefore, in practice, this could encompass shadow and de facto directors. It is also proposed that civil liability attaches to directors for delaying the opening of insolvency proceedings, whereby they may be liable to compensate creditors for damages.

Pre-pack proceedings – The proposals aim to ensure that pre-pack proceedings are available in a structured manner across the EU. It proposes that member states adopt pre-pack proceedings which consist of two consecutive phases (the "preparation phase" and the "liquidation phase").

- The preparation phase is concerned with finding an appropriate buyer. Under this phase, at the debtor's request, the court appoints a monitor. The monitor's role is, among other things, to ensure the sale process is competitive, transparent, fair and meets market standards, and report and document each step. "Market standards" refers to standard M&A rules and practice in the relevant member state, which includes equal disclosure to all potential buyers, and allowing interested parties to conduct due diligence. The monitor is responsible for recommending the best bidder as the pre-pack buyer, and also confirming that the best bid does not breach the best-interest-of-creditors test.

1 The Directive, as it stands, is not proposed to apply to debtors that are insurance undertakings, credit institutions, investment firms, central counterparties, central securities depositaries, certain financial institutions and public bodies.

- During the preparation phase, the debtor (in practice, the directors) continues to remain in control of the debtor company's assets and business operations. Although the preparation phase is not an insolvency proceeding, if the debtor is insolvent (or likely to become insolvent), they may be afforded a stay of individual enforcement actions. The monitor's fees during this stage are for the account of the debtor if there is no subsequent liquidation phase, or the insolvency estate as a preferential administrative expense if there is a subsequent liquidation phase.
- The liquidation phase is concerned with the approval and execution of the sale, and distribution of proceeds to creditors. During this phase, the court appoints the monitor as an insolvency practitioner and, subject to the monitor confirming that the sale process has been run in accordance with the requisite principles and conditions, approves the sale as proposed by the monitor. If the court does not approve the sale of the business to the bidder proposed by the monitor, the insolvency proceedings opened at the beginning of the liquidation phase will continue, but without concluding the pre-pack. Alternatively, member states may provide for a public auction to be elected. The public auction must be initiated within two weeks of the liquidation phase commencing, and cannot last for more than four weeks. In such cases, the best offer received during the preparation phase is to be used as a "stalking horse" bid (i.e. act as a purchase price floor).

Any executory contracts under which the parties have ongoing obligations at the time insolvency proceedings were opened may be assigned to the buyer even without the counterparty's consent. The sale of the business is conducted on a debt-free and liability-free basis.

The Directive lays down the foundations for interim financing into the debtor either during the preparation phase or the liquidation phase, which is afforded priority (much like a priming loan). Secured creditors are permitted to bid in the sale process and can potentially off set their secured claims against their bid price, provided, however, to avoid giving them an unfair advantage, credit bidding is only permitted where such creditor's secured claim is "significantly below" the market value of the debtor's business.

There are also additional safeguards applicable to potential buyers that are closely related to the debtor and, in particular, such bids warrant additional scrutiny to ensure they satisfy the best-interest-of-creditors test.

Finally, note that monitors and insolvency practitioners are personally liable for any damages caused by non-compliance with their obligations as set out in the Directive.

2. Efficiency of Insolvency Procedures

Simplified winding-up proceedings – The proposals note that all debtors are not equal, and, historically, small companies or microenterprises have had to deal with disproportionately higher costs of ordinary insolvency procedures. Therefore, it is proposed that simplified winding-up procedures be available for small insolvent companies whereby they can be wound up in an orderly, fast and cost-efficient manner. To facilitate this, the debtor or its creditors can make a request to the competent authority in their member state for the opening of simplified insolvency proceedings.

It is proposed that, subject to exceptions, the simplified winding-up procedure will be a debtor-in-possession process and no insolvency practitioner is to be appointed (as this is often an additional and not insubstantial cost). Ultimately, it will be down to the competent authorities in member states to specify whether an insolvency practitioner is necessary under the circumstances, and, if so, what specific rights and duties they have; for example, if they have the right to manage and dispose of the debtor's assets, or if such responsibility rests with the debtor, a creditor, or is subject to the approval of the competent authority.

The process, whilst simplified, still allows the debtor to benefit from a stay on individual enforcement action, albeit the competent authority can exclude claims from the scope of the moratorium. In terms of the general process that is envisaged, the competent authority will inform the debtor and all known creditors that simplified winding-up proceedings have been opened, and publish the same in the insolvency register. Creditors have up to 30 days of notification to lodge, amend or dispute claims.

3. Improving Predictability and Fair Distribution of Recovered Value Among Creditors

Avoidance actions – The avoidance provisions are intended to synergise with the bolstered asset tracing capabilities proposed under the Directive, in that they introduce minimum conditions for exercising avoidance actions and grant insolvency practitioners strengthened rights to access financial and beneficial ownership data and certain national asset registers (including in other member states).

The Directive proposes a minimum set of rules aimed at protecting the insolvency estate against illegitimate disposal of assets in the lead up to the opening of insolvency proceedings or submission of such request.

- **Preference** – Subject to exceptions, legal acts (including omissions) benefitting a creditor or group of creditors within three months prior to the submission of a request to open insolvency proceedings, or after such request, are potentially voidable. If the legal act was a due claim that was satisfied or secured in the expected manner, the act is only void if the creditor knew, or ought to have known, that the debtor was unable to pay its mature debts or that a request for opening insolvency proceedings had been submitted. Legal acts performed with fair consideration for the benefit of the insolvency estate are also exempt.

- **Legal acts for no or manifestly inadequate consideration** – Legal acts of the debtor for either no, or manifestly inadequate, consideration within one year prior to the submission of a request to open insolvency proceedings, or after such request, are potentially voidable.
- **Legal acts intentionally detrimental to creditors** – Legal acts whereby the debtor intentionally causes detriment to the general body of creditors are potentially voidable where (i) such act was perfected within four years prior to the submission of a request to open insolvency proceedings, or after such request, and (ii) the other party knew, or ought to have known, of the debtor's intention to cause detriment to the general body of creditors (such knowledge is presumed to be evident where the parties are connected or closely related).

The proposals clarify that new or interim financing obtained to facilitate either a restructuring of the debtor or in the course of a turnaround insolvency process under Title II of Directive (EU) 2019/1023 are not caught by the avoidance measures.

If a legal act is found to be void, the Directive provides that the party which benefitted from the relevant act is obliged to compensate the insolvency estate for the detriment caused to creditors. Such claims would be subject to certain defences and a limitation period of three years from the date that the relevant insolvency proceedings were opened.

Creditors' committees – To promote fair and predictable distribution of recovered assets among creditors, the Directive also proposes that member states facilitate the creation of creditors' committees either via a general meeting of creditors or appointed by the court, save in cases where it may not be cost efficient to do so, where there are only a few creditors, or if the debtor is a microenterprise.

The creditors' committee is to represent the interests of the whole body of creditors (albeit there is provision for multiple committees to be formed in order to represent different groups of creditors) and act independently of the insolvency practitioner.

The Directive also lays down the working methods and functions of the creditors' committee, including its rights, duties and powers. Member states are to determine how the expenses (and remuneration) of the creditors' committee is accounted for, and, if such costs are borne by the insolvency estate, stringent record keeping duties apply. Members of the creditors' committee are exempt from personal liability for their actions in their capacity as committee members, unless they have committed grossly negligent or fraudulent acts, wilful misconduct, or have breached a fiduciary duty to the creditors they represent.

Concluding Remarks

In general, the contents of the Directive will not come as a major surprise to the legal or the insolvency community, and various member states already have a number of these proposed measures in place. There are obvious benefits to harmonising insolvency laws – these processes are, by their nature, collective proceedings that increasingly contain cross-border elements (even in the case of SMEs).

In the EC's press release of 7 December, it forecast that the benefits of the proposal are expected to exceed €10 billion annually, as it is anticipated that these measures will even out the playing field among member states, reduce forum shopping, foster cross-border investment and lower the cost of capital for companies. Alignment of the rules around asset or value recovery will likely increase creditor or lender confidence in the long term and impact decisions to invest, risk models and ultimately, pricing.

Given that the Directive deals with quite a wide range of matters, it is likely that some parts (e.g. director's duties and avoidance) may be deemed more controversial than other parts (e.g. coordinated asset tracing mechanisms), and member states will be giving thought to how these proposals will potentially interplay with their existing rescue and turnaround processes. The overall effect of the package of proposals is to strengthen creditors' rights and positions, and, therefore, the Directive, if implemented, will mark a shift towards a more creditor-friendly era for some EU jurisdictions at least.

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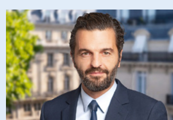

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